

1 UNITED STATES COURT OF APPEALS

2 FOR THE SECOND CIRCUIT

3 August Term, 2005

4 (Argued: April 21, 2006 Decided: September 7, 2006)

5 Docket No. 05-5527-bk

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7 - - - - -x

8  
9 In re NEW TIMES SECURITIES SERVICES,  
10 INC., and NEW AGE FINANCIAL SERVICES,  
11 INC.,

12  
13 Debtors,

14  
15 MARY ANN STAFFORD, RHEBA WEINE, JOEL  
16 WEINE,

17  
18 Plaintiffs-Appellees,

19  
20 - v.-

21  
22 JAMES GIDDENS, as Trustee for the  
23 Liquidation of the Substantially  
24 Consolidated Estates of New Times  
25 Securities Services, Inc. and New Age  
26 Financial Services, Inc., SECURITIES  
27 INVESTOR PROTECTION CORPORATION,

28  
29 Defendants-Appellants.

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31 - - - - -x

32 Before: WALKER, Chief Judge, JACOBS, and  
33 WALLACE, \* Circuit Judges.

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\*The Honorable J. Clifford Wallace, United States Court  
of Appeals for the Ninth Circuit, sitting by designation.

1           Appeal from a judgment of the United States District  
2   Court for the Eastern District of New York (Seybert, J.),  
3   reversing a judgment of bankruptcy court, which had denied  
4   claims under the Securities Investor Protection Act. We  
5   reverse, and remand to the district court with instructions  
6   to reinstate the judgment of the bankruptcy court.

7  
8                   JAMES B. KOBAK, JR. (Christopher  
9                   K. Kiplok, on the brief), Hughes  
10                  Hubbard & Reed LLP, New York,  
11                  NY, for Defendant-Appellant  
12                  James W. Giddens as Trustee for  
13                  the Liquidation of the  
14                  Businesses of New Times  
15                  Securities Services, Inc., and  
16                  New Age Financial Services, Inc.

17  
18                  CHRISTOPHER H. LAROSA, Assistant  
19                  General Counsel (Josephine Wang,  
20                  General Counsel, on the brief),  
21                  Securities Investor Protection  
22                  Corp., Washington, DC, for  
23                  Defendant-Appellant Securities  
24                  Investor Protection Corp.

25  
26                  MAY ORENSTEIN (Sigmund Wissner-  
27                  Gross, on the brief), Brown,  
28                  Rudnick, Berlack, Israels LLP,  
29                  New York, NY, for Plaintiffs-  
30                  Appellees.

1 DENNIS JACOBS, Circuit Judge:

2 In the wake of the bankruptcy of two brokerage houses<sup>1</sup>,  
3 plaintiffs-appellees Maryann Stafford and Rheba and Joel  
4 Weine ("plaintiffs") claimed an entitlement as "customers"--  
5 as defined by the Securities Investor Protection Act, 15  
6 U.S.C. §§ 78aaa et seq. ("SIPA" or the "Act")--to recover  
7 their losses from the funds SIPA reserves for such  
8 customers. The brokerage houses were instrumentalities of a  
9 Ponzi scheme engineered by their principal, William Goren;  
10 the plaintiffs, who were among the victims, had had accounts  
11 at the brokerage houses that contained substantial (but  
12 illusory) funds. The plaintiffs were induced to liquidate  
13 their accounts (in whole or in part) and make a loan of the  
14 imaginary funds to the brokerage houses and to Goren. The  
15 trustee for the SIPA liquidation of the brokerage houses  
16 ("Trustee") concluded that the plaintiffs were lenders, not  
17 "customers," and denied their claims to SIPA funds, and the  
18 United States Bankruptcy Court for the Eastern District of  
19 New York (Cyganowski, B.J.) agreed. The United States  
20 District Court for the Eastern District of New York

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<sup>1</sup>New Times Securities Services, Inc. and New Age  
Financial Services, Inc.

1 (Seybert, J.) reversed, and this appeal is taken from that  
2 judgment by the Trustee and the Securities Investor  
3 Protection Corporation (the "SIPC"). We reverse, and remand  
4 to the district court with instructions to reinstate the  
5 judgment of the bankruptcy court.

6  
7 **I**

8 The facts of the case are undisputed. Goren conducted  
9 a Ponzi scheme using the two brokerage houses (the  
10 "Debtor"). He solicited investments in fictional money  
11 market funds; he pretended to invest in genuine money market  
12 funds; and he issued fraudulent promissory notes. See In re  
13 New Times Sec. Servs., Inc., 371 F.3d 68, 71 (2d Cir. 2004).  
14 In 1998, Stafford and the Weines invested (\$75,000 and  
15 \$35,000, respectively) with Goren for the purchase of  
16 securities. In 1999, they voluntarily authorized Goren to  
17 sell some or all of their securities accounts and reinvest  
18 the proceeds in interest-bearing promissory notes, with  
19 Goren and the Debtor as obligors.

20 On February 17, 2000, the SEC filed a complaint against  
21 the Debtor, and applied for orders freezing the Debtor's  
22 assets and appointing a temporary receiver. The district

1 court granted the orders the next day. The statutory filing  
2 date for SIPA purposes is therefore February 17, 2000. See  
3 15 U.S.C. § 78111(7)(B). On that date, the plaintiffs were  
4 holding the promissory notes. The Debtor was subsequently  
5 placed into SIPA liquidation, and the Trustee was appointed  
6 to oversee the liquidation under procedures established by  
7 the bankruptcy court.

8 The plaintiffs filed SIPA customer claims with the  
9 Trustee; the Trustee denied the claims insofar as they  
10 sought SIPA protection for the face amount of their  
11 promissory notes. The bankruptcy court affirmed the  
12 Trustee's rejection of the claims, holding that SIPA  
13 customer status is determined as of the filing date of a  
14 debtor liquidation and that the promissory notes held by  
15 plaintiffs at the filing date rendered them "lenders," not  
16 "customers," for SIPA purposes.<sup>2</sup> The district court  
17 reversed the bankruptcy court, on the ground that the

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<sup>2</sup>The bankruptcy court noted that the Eastern District of New York had arrived at the same conclusion in a case involving litigants who also possessed the worthless promissory notes on the date of filing, but who had made those investments directly (and not with the proceeds from liquidation of their brokerage accounts). See SEC v. Goren, 00-CV-970/800-8178-288 (E.D.N.Y. 2002) (Memorandum and Order).

1 plaintiffs' original securities investments with the Debtor  
2 established their status as "customers" and that their  
3 subsequent decision--fraudulently induced by Goren--to  
4 liquidate those securities investments and provide Goren and  
5 the Debtor with loans in exchange for promissory notes did  
6 not change their "customer" status.

## 7 8 II

9 We review de novo the district court's conclusions of  
10 law and its application of law to the undisputed facts. See  
11 Pereira v. Farace, 413 F.3d 330, 341 (2d Cir. 2005).

12 "The principal purpose" of SIPA is "to protect  
13 investors against financial losses arising from the  
14 insolvency of their brokers." SEC v. S. J. Salmon & Co.,  
15 375 F. Supp. 867, 871 (S.D.N.Y. 1974). The Act advances  
16 this purpose by according those claimants in a SIPA  
17 liquidation proceeding who qualify as "customers" of the  
18 debtor priority over the distribution of "customer  
19 property."<sup>3</sup> See 15 U.S.C. §§ 78fff-2(b) & (c)(1), 78lll(4).

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<sup>3</sup>SIPA defines "Customer Property" as "cash and securities . . . at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property

1 Each customer shares ratably in this fund of assets to the  
2 extent of the customer's net equity at the time of filing.<sup>4</sup>  
3 See 15 U.S.C. § 78fff-2(c)(1)(B). If the fund of customer  
4 property is insufficient to make the customers whole, the  
5 government makes up the difference--subject to a cap--out of  
6 a special SIPC fund capitalized by the general brokerage  
7 community. See 15 U.S.C. §§ 78fff-3, 78ddd; see also SEC v.  
8 Packer, Wilbur & Co., 498 F.2d 978, 980 (2d Cir. 1974).

9 "Judicial interpretations of 'customer' status support  
10 a narrow interpretation of the SIPA's provisions." In re  
11 Stalvey & Assocs., Inc., 750 F.2d 464, 472 (5th Cir. 1985)  
12 accord In re Kline, Maus & Shire, Inc., 301 B.R. 408, 418  
13 (Bankr. S.D.N.Y. 2003) (collecting cases). "The Act  
14 contemplates that a person may be a 'customer' with respect  
15 to some of his claims for cash or shares, but not with  
16 respect to others." SEC v. F. O. Baroff Co., 497 F.2d 280,  
17 282 n.2 (2d Cir. 1974). A specific distinction is drawn  
18 between (i) "customers" and (ii) those in a lending  
19 relationship with the debtor (i.e., "lenders"):

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unlawfully converted." 15 U.S.C. § 78lll(4).

<sup>4</sup>SIPA defines "net equity" as "the dollar amount of the account or accounts of a customer." 15 U.S.C. § 78lll(11).

1       The term "customer" of a debtor means any  
2       person . . . who has a claim on account of  
3       securities received, acquired, or held by the  
4       debtor in the ordinary course of its business  
5       as a broker or dealer from or for the  
6       securities accounts of such person for  
7       safekeeping, with a view to sale, to cover  
8       consummated sales, pursuant to purchases, as  
9       collateral security, or for purposes of  
10      effecting transfer. The term "customer"  
11      includes any person who has a claim against  
12      the debtor arising out of sales or conversions  
13      of such securities, and any person who has  
14      deposited cash with the debtor for the purpose  
15      of purchasing securities, but does not  
16      include--

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18       \* \* \* \*

19  
20               (B) any person to the extent that such  
21               person has a claim for cash or securities  
22               which by contract, agreement, or  
23               understanding, or by operation of law, is  
24               part of the capital of the debtor, or is  
25               subordinated to the claims of any or all  
26               creditors of the debtor . . . .

27  
28       15 U.S.C. § 78111(2) (emphasis added); see also Appleton v.  
29       First Nat'l Bank of Ohio, 62 F.3d 791, 801 (6th Cir. 1995)  
30       (stating that "[t]he critical aspect of the 'customer'  
31       definition is the entrustment of cash or securities to the  
32       broker-dealer for the purposes of trading securities.").

33       That subsection (2), which was added to SIPA in 1978,  
34       see Pub. L. No. 95-283, 92 Stat. 249, thus distinguishes  
35       between (i) claimants (protected as customers) who are

1 engaged through brokers in trading activities in the  
2 securities markets and (ii) those (unprotected) claimants  
3 who are relying on the ability of a business enterprise to  
4 repay a loan.<sup>5</sup> "Lenders are simply not a class to be  
5 specially protected under SIPA and in fact were expressly  
6 excluded from the definition of customer upon the enactment  
7 of the 1978 amendments to SIPA." In re Hanover Square Sec.,  
8 55 B.R. 235, 238-39 (Bankr. S.D.N.Y. 1985). Whether an  
9 individual enjoys "customer" status thus turns on the  
10 transactional relationship. See Baroff, 497 F.2d at 284  
11 (contrasting indicia of "the fiduciary relationship between  
12 a broker and his public customer" with characteristics of  
13 "an ordinary debtor-creditor relationship"). A loan  
14 transaction that is unrelated to trading activities in the  
15 securities market does not qualify for SIPA protection.

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<sup>5</sup>This distinction was first drawn in opinions by this court. See Baroff, 497 F.2d at 284; Sec. Investor Prot. Corp. v. Exec. Sec. Corp., 556 F.2d 98, 99 (2d Cir. 1977) (per curiam) ("Congress intended to protect the public customer 'as investor and trader, not . . . others who might become creditors of the broker-dealer for independent reasons.'" (emphasis and alteration in original) (quoting Baroff, 497 F.2d at 283)). Apparently, through the passage of the 1978 amendments to SIPA, Congress "intended to codify decisions such as Baroff and Executive Securities." In re Hanover Square Secs., 55 B.R. 235, 239 (Bankr. S.D.N.Y. 1985 (citing to a 1978 Senate Committee hearing)).

1           The SIPA scheme assumes that a customer--as an investor  
2   in securities--wishes to retain his investments despite the  
3   liquidation of the broker; the statute thus "works to expose  
4   the customer to the same risks and rewards that would be  
5   enjoyed had there been no liquidation." 6 Collier on Bankr.  
6   P 741.06[6] (Alan N. Resnick & Henry J. Sommer eds., 15th  
7   ed. rev.); see also In re Adler Coleman Clearing Corp., 195  
8   B.R. 266, 274 (Bankr. S.D.N.Y. 1996). It is a customer's  
9   legitimate expectations on the filing date--here, February  
10   17, 2000--that determines the availability, nature, and  
11   extent of customer relief under SIPA. See 15 U.S.C. §§  
12   78fff-2(b), 78111(7) & (11); see also In re New Times Secs.  
13   Servs., Inc., 371 F.3d 68, 87 (2d Cir. 2004) (suggesting  
14   that principle that a "customer's 'legitimate expectations,'  
15   based on written confirmations of transactions, ought to be  
16   protected" informs interpretation of SIPA); In re Stratton  
17   Oakmont, No. 01-CV-2812, 2003 WL 22698876, at \*7 (S.D.N.Y.  
18   Nov. 14, 2003) ("[W]hether customers have claims for  
19   securities or for cash hinges on what they expected to have  
20   in their accounts on the filing date."); Adler Coleman, 195  
21   B.R. at 274 ("[T]he Trustee must promptly deliver customer  
22   name securities to the debtor's customers as they are

1 entitled to receive them and to distribute customer property  
2 and otherwise satisfy customer net equity claims to the  
3 extent provided for in § 78fff."); S. Rep. No. 95-763, at 2  
4 (1978), reprinted in 1978 U.S.C.C.A.N. 764, 765 ("By seeking  
5 to make customer accounts whole and returning them to  
6 customers in the form they existed on the filing date, the  
7 [1978] Amendments not only would satisfy the customers'  
8 legitimate expectations, but also would restore the customer  
9 to his position prior to the broker-dealer's financial  
10 difficulties.").

11 The promissory notes held by the plaintiffs on the  
12 filing date entitled them as holders to (i) a return of  
13 principal at a fixed time and (ii) interest at a fixed rate  
14 (18 percent); these are just the type of debt instruments  
15 whose possession brings claimants within the category of  
16 unprotected lenders.<sup>6</sup> See In re Mason Hill & Co., Nos. 95-  
17 99999, 02-8030A, 2003 WL 23509197, at \*4 (Bankr. S.D.N.Y.  
18 Dec. 10, 2003) (denying SIPA "customer" status to holder of  
19 "essentially a promissory note"); Hanover Square, 55 B.R. at  
20 238 (denying SIPA "customer" status to holders of

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<sup>6</sup>Plaintiffs do not contest that their investment in the promissory notes would normally bring them out of the ambit of SIPA "customer" status.

1     subordinated loan agreements collateralized by securities).<sup>7</sup>

2             The district court concluded that because the  
3     plaintiffs were fraudulently induced to invest in the  
4     promissory notes, their legitimate expectations essentially  
5     froze at the moment that they sold their securities, and  
6     they therefore retain customer claims for "cash"--defined as  
7     money deposited with the broker (but not actually invested  
8     in securities).<sup>8</sup> In reaching this conclusion, the district  
9     court relied on In re New Times Securities Services, in  
10    which customers deposited money with a broker for the  
11    purchase of securities that turned out to be wholly  
12    fictitious. 371 F.3d at 71-72. The New Times court  
13    determined that the customers had claims for securities,  
14    even though their "securities" were fictitious, because they  
15    had a legitimate expectation that they had invested in

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<sup>7</sup>The district court agreed that "at the time of the filing date, [the plaintiffs] believed they were creditors, not customers."

<sup>8</sup>Under SIPA, the only relevant difference between a customer claim for cash and a customer claim for securities is in the maximum limit that SIPC may advance to the SIPC trustee to satisfy customer claims that cannot be met from the customer property; the maximum for securities is \$500,000, see 15 U.S.C. § 78fff-3(a), while the maximum for cash is \$100,000, see § 78fff-3(a)(1). See In re New Times Secs. Servs., 371 F.3d at 73.

1 securities. See id. at 86 (“[W]e find that because the  
2 Claimants directed that the money they placed with the  
3 Debtors be used to purchase securities--and, importantly,  
4 because they received confirmations and account statements  
5 reflecting such purchases--they are not the types of cash  
6 depositors envisioned by the drafters of the ‘claims for  
7 cash’ provision.”). Because there were no such securities,  
8 and it was therefore impossible to reimburse customers with  
9 the actual securities or their market value on the filing  
10 date (the usual remedies when customers hold specific  
11 securities), the New Times court determined that the  
12 securities should be valued according to the amount of the  
13 initial investment. See id. at 87-88. The court declined  
14 to base the recovery on the rosy account statements telling  
15 customers how well the imaginary securities were doing,  
16 because treating the fictitious paper profits as within the  
17 ambit of the customers’ “legitimate expectations” would lead  
18 to the absurdity of “duped” investors reaping windfalls as a  
19 result of fraudulent promises made on fake securities. See  
20 id.

21 New Times does not support the plaintiffs’ claims. In  
22 New Times, the customers were customers for securities

1 because they had a legitimate belief that they were  
2 investing in securities. The court looked to the initial  
3 investment as the measure for reimbursement because the  
4 initial investment amount was the best proxy for the  
5 customers' legitimate expectations. In contrast, the  
6 plaintiffs here decided to swap their SIPA-protected  
7 securities investments for non-protected loan instruments.  
8 The plaintiffs authorized the loans, received confirmation  
9 and account statements indicating that they had made the  
10 loans (and referring to the instruments as "private notes"),  
11 and accepted interest payments in connection with the loans.  
12 Their only legitimate expectation must have been that they  
13 were lenders. True, they started as customers, and they  
14 would have been victimized in that status but for other  
15 fraudulently-induced transactions; so there is an unreal  
16 cast to the transactions that altered the expectations that  
17 govern under SIPA. However, as noted supra, "customer  
18 status in the course of some dealings with a broker will not  
19 confer that status upon other dealings, no matter how  
20 intimately related, unless those other dealings also fall  
21 within the ambit of the statute." In re Stalvey, 750 F.2d  
22 at 471; see Baroff, 497 F.2d at 282 n.2. The plaintiffs

were defrauded by their broker, but "SIPA does not protect against all cases of alleged dishonesty and fraud." In re Stratton Oakmont, Inc., 239 B.R. 698, 701-02 (S.D.N.Y. 1999); see S. J. Salmon & Co., 375 F. Supp. at 870-71.

\* \* \*

The judgment of the district court is reversed, and the case is remanded to the district court with instructions to reinstate the judgment of the bankruptcy court.